treat the income as high-withholding tax interest.

[T.D. 8214, 53 FR 27034, July 18, 1988, as amended by T.D. 8412, 57 FR 20653, May 14, 1992]

§ 1.904(b)–1 Treatment of capital gains for corporations.

(a) *In general.* For purposes of computing the foreign tax credit limitation of corporations, the following rules apply:

(1) *Inclusion in foreign source taxable income.* The taxable income of a corporation from sources without the United States includes gain from the sale or exchange of capital assets only in an amount equal to—

(i) Foreign source capital gain net income (as defined in paragraph (b)(2) of this section), reduced by

(ii) The rate differential portion (as defined in paragraph (b)(5) of this section) of foreign source net capital gain (as defined in paragraph (b)(4) of this section).

(2) *Inclusion in entire taxable income.* The entire taxable income of a corporation includes gain from the sale or exchange of capital assets only in an amount equal to—

(i) Capital gain net income (as defined in paragraph (b)(1) of this section), reduced by

(ii) The rate differential portion of net capital gain (as defined in paragraph (b)(3) of this section).

(3) *Treatment of capital losses.* The taxable income of a corporation from sources without the United States shall be reduced by an amount equal to—

(i) Any net capital loss (as defined in paragraph (b)(6) of this section) allocable or apportionable to sources without the United States to the extent taken into account in determining capital gain net income for the taxable year, less

(ii) An amount equal to the rate differential portion of the excess of net capital gain from sources within the United States over net capital gain (from all sources).

(b) *Definitions.* For purposes of section 904(b) and §§ 1.904(b)–1 through (b)–3, the following definitions shall apply:

(1) *Capital gain net income.* The term *capital gain net income* means the excess of the gains from the sales or exchanges of capital assets over the losses from such sales or exchanges. Such term shall include net section 1231 gain, but shall not include gains from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining capital gain net income, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(2) *Foreign source capital gain net income.* The term *foreign source capital gain net income* means the lesser of—

(i) Capital gain net income from sources without the United States, or

(ii) Capital gain net income (from all sources).

(3) *Net capital gain.* The term *net capital gain* means the excess of the net long-term capital gain (including net section 1231 gain) for the taxable year over the net short-term capital loss for such year, but shall not include gains from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining net capital gain, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(4) *Foreign source net capital gain.* The term ''*foreign source net capital gain* means the lesser of—

(i) Net capital gain from sources without the United States, or

(ii) Net capital gain (from all sources).

(5) *Rate differential portion.* The term *rate differential portion* of foreign source net capital gain, net capital gain, or the excess of net capital gain from sources within the United States over net capital gain, as the case may be, is the same proportion of such amount as the excess of the highest rate of tax specified in section 11(b) over the alternative rate of tax under section 1201(a) bears to the highest rate of tax specified in section 11(b).

(6) *Net capital loss.* Except as provided in § 1.904(b)–2(b), the term *net capital loss* means the excess of the losses from sales and exchanges of capital assets

over the sum allowed under section 1211. For purposes of paragraph (a) of this section, the term ''net capital loss'' includes any amounts which are short-term capital losses under section 1212(a). Net capital losses do not include losses from the sales or exchanges of capital assets which are not treated as capital losses under the Internal Revenue Code. In determining net capital loss, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(7) *Allocation and apportionment.* For purposes of this section and § 1.904 (b)–2 and (b)–3, the rules under § 1.861–8(e)(7) with respect to the allocation and apportionment of losses are to be applied with respect to losses on the sale, exchange or other disposition of property.

(8) *Computation of net section 1231 gain.* For purposes of this section and § 1.904(b)–2, the netting of section 1231 gains and losses is determined by aggregating the gains and loss from sources both within and without the United States. The gain or loss determined by this aggregation determines the character of the section 1231 gains (and losses allocable or apportionable thereto) from sources without the United States and from all sources for purposes of computing the foreign tax credit limitation fraction.

(c) *Illustrations.* The principles of paragraph (a) of this section may be illustrated by the following examples:

Example 1. Corporation A had the following business taxable income, capital gains and capital losses for 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$1,200	$2,000	$3,200
Long-term capital gain	300	200	500
Long-term capital loss	0	400	400
Short-term capital gain	100	400	500
Short-term capital loss	200	300	500

For purposes of computing the foreign tax credit limitations, the foreign source taxable income and the entire taxable income of A are computed as follows:

Step (1) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	$300	$100
Net long-term capital loss	0	0
Net short-term capital gain	0	0
Net short-term capital loss	100	0

Step (2) Next compute capital gain net income and net capital gain from sources without the United States and from all sources as follows:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) $200	(b) $100
Net capital gain	(c)200	(d)100

Step (3) Next calculate foreign source capital gain net income and foreign source net capital gain, which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is $100,000, and foreign source net capital gain is $100,000.

Step (4) Compute taxable income from sources without the United States, using $^{18}/_{46}$ as the rate differential portion, as follows:

Foreign business income + Foreign source capital gain net income $-{}^{18}/_{46}$ (foreign source net capital gain)

$1,200,000 + $100,000 $-{}^{18}/_{46}$ ($100,000) (39,130)=$1,260,870

Step (5) Compute the entire taxable income as follows:

Business income + Capital gain net income $-{}^{18}/_{46}$ (net capital gain)

$3,200,000 + $100,000 $-{}^{18}/_{46}$ ($100,000) (39,130)=$3,260,870

Example 2. Corporation B had the following business taxable income, capital gains, and capital losses for 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$1,200	$2,000	$3,200
Long-term capital gain	300	200	500
Long-term capital loss	500	100	600
Short-term capital gain	600	200	800
Short-term capital loss	100	200	300

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of B are computed as follows:

Step (1) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without U.S.	All sources
Net long-term capital gain	0	0
Net long-term capital loss	$200	$100
Net short-term capital gain	500	500
Net short-term capital loss	0	0

Step (2) Next compute capital gain net income and net capital gain from sources without the United States and from all sources as follows:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) $300	(b) $400
Net capital gain	(c) 0	(d) 0

Step (3) Next calculate foreign source capital gain net income and foreign source net capital gain which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is $300,000 and foreign source net capital gain is zero.

Step (4) Compute taxable income from sources without the United States, using $^{18}\!/_{46}$ as the rate differential portion, as follows:

Foreign business income+Foreign source capital gain net income $-\,^{18}\!/_{46}$ (foreign source net capital gain)

$1,200,000+300,000—$^{18}\!/_{46}$ (0)=$1,500,000

Step (5) Compute the entire taxable income as follows:

Business income+Capital gain net income $-\,^{18}\!/_{46}$ (net capital gain)

$3,200,000+$400,000 $-\,^{18}\!/_{46}$ (0)=$3,600,000

Example 3. Corporation C had the following business taxable income, capital gains, and capital losses for 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$1,200	$2,000	3,200
Long-term capital gain	200	500	700
Long-term capital loss	600	100	700
Short-term capital gain	300	400	700
Short-term capital loss	500	100	600

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of C are computed as follows:

Step (*1*) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	0	0
Net long-term capital loss	$400	0
Net short-term capital gain	0	$100
Net short-term capital loss	200	0

Step (*2*) Next compute capital gain net income and net capital gain from sources without the United States and from all sources:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) 0	(b) $100
Net capital gain	(c) 0	(d) 0

Step (*3*) Next calculate foreign source capital gain net income and foreign source net capital gain which is the lesser of (a) or (b) and the lesser of (c) or (d) respectively. Foreign source capital gain net income is zero and foreign source net capital gain is zero.

Step (*4*) Under paragraph (a)(3)(i) of this section, the taxable income from sources without the United States is reduced by the amount by which the net capital loss allocable or apportionable to sources without the United States reduces capital gains (long and short-term) from sources within the United States when computing capital gain net income. This is determined by first computing the net capital loss allocable or apportionable to sources without the United States ($600,000) and the capital gain net income from sources within the United States ($700,000). In this case, $600,000 of net capital loss allocable or apportionable to sources without the United States reduces $600,000 of net long and short-term capital gains from sources within the United States in computing capital gain net income.

Step (*5*) Under paragraph (a)(3)(ii) of this section, the adjustment under paragraph (a)(3)(i) of this section is reduced by an amount equal to the rate differential portion of net capital gain from sources within the United States over net capital gain (from all sources). In this case, net capital gain from sources within the United States is $400,000 and net capital gain is zero, so an amount equal to $^{18}\!/_{46}$ multiplied by $400,000 is added to the numerator of the foreign tax credit limitation fraction in computing taxable income from sources without the United States.

Step (*6*) Computation of foreign tax credit limitation fraction.

(i) Taxable income from sources without the United States is as follows:

Foreign business income + Foreign source capital gain net income − 18⁄46 (foreign source net captial gain) − paragraph (a)(3)(i) adjustment − paragraph (a)(3)(ii) adjustment

$$\$1{,}200{,}000 + 0 - 0 - \$600{,}000 + {}^{18}\!/_{46}\frac{(\$400{,}000)}{(\$156{,}522)} = \$756{,}522$$

(ii) The entire taxable income is as follows:

Business income+Capital gain net income—18⁄46 (net capital gain)

$3,200,000 + $100,000 − 0 = $3,300,000

Note that no adjustment under paragraph (a)(3) is made with respect to the denominator.

Example 4. Corporation D had the following business taxable income, capital gains and capital losses in 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$2,000	$2,500	$4,500
Long-term capital gain	100	200	300
Long-term capital loss	100	100	200
Short-term capital gain	300	400	700
Short-term capital loss	800	....	800

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income are computed as follows:

Step (1) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionate to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	0	100
Net long-term capital loss	0	0
Net short-term capital gain	0	0
Net short-term capital loss	500	100

Step (2) Next compute capital gain net income and net capital gain from sources without the United States and from all sources:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) 0	(b) 0
Net capital gain	(c) 0	(d) 0

Step (3) Next compute foreign source capital gain net income and foreign source net capital gain, which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is zero and foreign source net capital gain is zero.

Step (4) Under paragraph (a)(3)(i) of this section, the taxable income from sources without the United States is reduced by the amount by which the net capital loss allocable or apportionable to sources without the United States reduces capital gains (long- and short-term) from sources within the United States when computing capital gain net income. This is determined by first computing the net capital loss allocable or apportionable to sources without the United States ($500,000), and the capital gain net income from sources within the United States ($500,000). In this case, $500,000 of net capital loss allocable or apportionable to sources without the United States reduces $500,000 of net long- and short-term gains from sources within the United States in computing capital gain net income.

Step (5) Under paragraph (a)(3)(ii) of this section, the adjustment under paragraph (a)(3)(i) of this section is reduced by an amount equal to the rate differential portion of net capital gain from sources within the United States over net capital gain (from all sources). In this case, net capital gain from sources within the United States is $100,000 and the net capital gain is zero, so an amount equal to 18⁄46 multiplied by $100,000 is added to the numerator of the foreign tax credit limitation fraction in computing taxable income from sources without the United States.

Step (6) Computation of foreign tax credit limitation fraction.

(i) Taxable income from sources without the United States is as follows:

Foreign business income + Foreign source capital gain net income − 18/46 (foreign source net capital gain) − (paragraph (a)(3)(i) adjustment − paragraph (a)(3)(ii) adjustment)

$$\$2{,}000{,}000 + 0 - 0 - \$500{,}000 + {}^{18}\!/_{46}\frac{(\$100{,}000)}{(\$39{,}130)} = \$1{,}539{,}130$$

(ii) The entire taxable income is determined as follows:

Business income + Capital gain net income − 18⁄46 (net capital gain)

$4,500,000 + 0 − 0 = $4,500,000

Note that no adjustment under paragraph (a)(3) of this section is made with respect to the denominator.

[T.D. 7914, 48 FR 44520, Sept. 29, 1983]

§ 1.904(b)–2 Treatment of capital gains for other taxpayers.

(a) *In general.* For purposes of computing the foreign tax credit limitation of persons other than corporations, the following rules apply:

(1) *Inclusion in foreign source taxable income.* The taxable income from sources without the United States shall include gain from the sale or exchange of capital assets only to the extent of foreign source capital gain net income (as defined in paragraph (b)(2) of § 1.904(b)–1), reduced by an amount determined by multiplying foreign source net capital gain (as defined in paragraph (b)(4) of § 1.904(b)–1) by the percentage specified under section 1202(a).

(2) *Inclusion in entire taxable income.* The entire taxable income of a taxpayer other than a corporation shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income (as defined in paragraph (b)(1) of § 1.904(b)–1), reduced by an amount determined by multiplying net capital gain (as defined in paragraph (b)(3) of § 1.904(b)–1) by the percentage specified under section 1202(a).

(3) *Treatment of capital losses.* The taxable income from sources without the United States shall be reduced by:

(i) Any net capital loss (as defined in paragraph (b) of this section) allocable or apportionable to sources without the United States to the extent taken into account in determining capital gain net income, less

(ii) An amount equal to the excess of net capital gain from sources within the United States over net capital gain, multiplied by the percentage specified under section 1202(a).

(b) *Definition of net capital loss.* For purposes of paragraph (a) of this section, the term *net capital loss* means the excess of the losses from the sale or exchange of capital assets treated as capital losses under the Internal Revenue Code and any carryforward as determined under section 1212 over the amount allowed under section 1211(b). In determining net capital loss, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(c) *Illustrations.* The principles of paragraph (a) of this section are illustrated by the following examples:

Example 1. X, an individual, has $1,500,000 of foreign source taxable income and $2,500,000 of U.S. source taxable income (exclusive of capital gains and losses) for 1979 and the following capital gains and losses:

	In thousands		
	Foreign source	U.S. source	All sources
Long-term capital gain	$300	$500	$800
Long-term capital loss	100	500	600
Short-term capital gain	100	400	500
Short-term capital loss	100	200	300

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of X are computed as follows:

Step (1) First, compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows: